POSTED 02-21-02

KIAWAH ISLAND UTILITY, INC.

DOCKET NO. 2001-164-W/S

PRE-FILED TESTIMONY OF JOHN F. GUASTELLA

BEFORE THE SOUTH CAROLINA PUBLIC SERVICE COMMISSION

Testimony Prepared: February 20, 2002

Hearing Date: March 13, 2002

THIS TESTIMONY IS FILED PURSUANT TO PSC ORDER DATED JANUARY 15, 2002. THE APPLICANT RESERVES THE RIGHT TO SUPPLEMENT THIS TESTIMONY AND TO PROVIDE REPLY TESTIMONY TO THE TESTIMONY THAT WILL BE PRE-FILED BY THE COMMISSION STAFF AND INTERVENORS.

MR. WALKER: Please state your name and business address.

MR. GUASTELLA: John F. Guastella, Guastella Associates, Inc., 100 Boylston Street, Boston, MA 02116.

MR. WALKER: By whom are you employed?

MR. GUASTELLA: I am president of Guastella Associates, Inc.

MR. WALKER: Please describe Guastella Associates, Inc.

MR. GUASTELLA: Guastella Associates, Inc. provides utility management, valuation and rate consulting services to both regulated and unregulated utilities.

MR. WALKER: Please describe your educational, professional and business background and experience.

MR. GUASTELLA: I graduated from Stevens Institute of Technology in June of 1962, receiving a degree in Mechanical Engineering. I have completed courses in utility regulation sponsored by the National Association of Regulatory Utility Commissioners

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(NARUC) and conducted by the University of Colorado, the University of South Florida, Florida Atlantic University, the University of Utah and Florida State University.

I was employed by the New York State Public Service Commission for sixteen years from 1962 to 1978. With the exception of two years in which I was involved in the regulation of electric and gas utilities, my time with the New York Commission was devoted to the regulation of water utilities. After a series of promotions during the years 1962 to 1970, attained through competitive examinations, I was promoted to Chief of Rates and Finance in the Commission's Water Division. In 1972 I was made Assistant Director of the Water Division. In 1974 I was appointed by the Chairman of the Commission as Director of the Water Division, a position I held until my resignation from the Commission in August of 1978.

My duties with the Commission included the performance and supervision of various engineering and economic studies concerning valuation of utility property, financing, rates and service of electric, gas and water utilities. While in the Water Division, I either examined or supervised the examination of the books and records of literally hundreds of water utilities.

As Director of the Water Division, I was responsible for the regulation of more than 450 water companies in New York State, heading a professional staff consisting of 32 engineers and three technicians. One of my primary duties was to advise the Commission during its adjudication of formal proceedings, as well as other matters. In the course of those deliberations, testimony, exhibits and briefs submitted in formal proceedings were reviewed and analyzed. My duties and responsibilities covered such subjects as the reasonableness of investments in utility plant, appropriate depreciation,

contributions in aid of construction, advances in aid of construction, construction work in progress, working capital, amortizations, rate base, revenue level, operation and maintenance expenses, taxes, cost of capital, fundable capital, financing, capital structure, rate of return, rate design, rate structure, quality of service and, in general, all aspects of utility valuation, rate setting and service.

Another major responsibility was the review of all proposed legislation affecting water utilities in New York and the subsequent preparation of recommendations for use by the governor or the legislature in considering such legislation. I also made legislative proposals and participated directly in drafting bills that were enacted: one expanded the New York Commission's jurisdiction with respect to the regulation of the service provided by small water companies and another dealt specifically with rate regulation and financing of developer-related water systems. During my employment with the New York Commission, I handled or supervised the handling of thousands of consumer complaints by individuals, corporations and municipal, governmental and political officials.

In 1978, I formed Guastella Associates, Inc. Concurrently with my position as President of Guastella Associates, Inc., I served as President of Country Knolls Water Works, Inc. from 1987 to 1991, directing the management and operation of this utility which served some 5,000 customers.

I have prepared appraisals and valuations of utility property, depreciation studies, rate analyses, cost allocation and rate design studies, and management and financial analyses. I have provided consulting services for municipal and investor-

owned water and sewer utilities, as well as gas utilities and solid waste collection and disposal companies.

MR. WALKER: Before what regulatory agencies and municipal jurisdictions have you previously presented expert testimony?

MR. GUASTELLA: I have presented expert testimony in the states of Connecticut, Delaware, Florida, Illinois, Indiana, Massachusetts, Missouri, Montana, Nevada, New Jersey, New Mexico, New York, North Dakota, Texas, Ohio, Pennsylvania, Virginia and Rhode Island.

MR. WALKER: Briefly state your activities in connection with professional organizations and associations.

MR. GUASTELLA: I served as Vice-Chairman of the Staff-Committee on Water of the National Association of Regulatory Utility Commissioners (NARUC). While on that committee, I prepared a 95-page instruction manual entitled, "Model Record-Keeping Manual for Small Water Companies," which was published by the NARUC. The manual describes in detail the kinds of operating and accounting records that should be kept by small water utilities, with instructions on how to use those records in order to properly operate a water system and properly keep account of the cost of providing service.

Since 1974 I have prepared the rate case study material, assisted in the coordination of the program and served as an instructor at the Annual Fall Seminar on Water Rate Regulation sponsored by the NARUC and conducted by the University of South Florida, Florida Atlantic University, University of Utah, and Florida State University. This seminar is recognized as being one of the best in the country for teaching rate-setting principles and methodology. It is attended by representatives of

regulatory agencies, utilities and engineering, accounting, economic and law firms throughout the country. In 1980, as a special consultant to NARUC, I assisted in the establishment of another similar seminar, which has been held annually in the spring in the western United States. In 1998, I prepared and conducted a rate regulation seminar in Maine on behalf of the New England Chapter of the National Association of Water Companies (NAWC).

In 2000, in conjunction with Florida State University, I established a special seminar for Developer-Related and Small Water and Sewer Utilities, which has been held annually. This seminar provides instruction as to the financial structuring, financing, rate setting and regulatory requirements for small investor-owned utilities.

I served as an instructor and panelist in a seminar on water and sewer utility regulation conducted by the Independent Water and Sewer Companies of Texas. As a member of the NAWC, I serve on its Rates and Revenue Committee and Small Company Committee. I am a member of the American Water Works Association (AWWA) and served on its Water Rates Committee, and assisted in the preparation of the AWWA Rates Manual, Third Edition. I have also served on a joint committee on rate design composed of staff members of NARUC and NAWC. In connection with my serving on these committees, and in connection with cost allocation and rate design studies I have performed in the course of my work, I have participated in decisional meetings to determine proper engineering and construction criteria in relation to costs in the design of water and sewer systems.

I have prepared and presented papers at a number of meetings of the National Association of Water Companies, the National Association of Regulatory Utility

Commissioners, the New England Conference of Public Utilities Commissioners, and at meetings of the Mid-America Regulatory Conference, the Public Utility Law Section of the New Jersey Bar Association, the Pennsylvania Environmental Council, the Southeastern Association of Regulatory Utility Commissioners, the New Jersey Chapter of the American Water Works Association, and the Florida, New England, New Jersey and New York chapters of NAWC.

MR. WALKER: What is the nature of your involvement in this proceeding?

MR. GUASTELLA: My firm has been retained by Kiawah Island Utility, Inc. ("Company" or "KIU") to provide consulting services in connection with the preparation of a rate filing for its water and sewer utility operations. Mr. Gary C. White of my firm and I coordinated our efforts as well as those of Company personnel to carry out this assignment.

MR. WALKER: Would you please describe the scope of your work?

MR. GUASTELLA: We examined financial and operating data obtained from the Company's books and records furnished to us by Company employees and representatives. We reviewed decisions by the South Carolina Public Service Commission regarding KIU's previous rate filings and related other documents in those cases. We also reviewed PSC decisions in other cases. We have met with Company employees and representatives, we have made an inspection of the water and sewer facilities, and we toured the service area.

MR. WALKER: Have schedules been prepared by you or under your supervision in order to support the Company's rate filing?

MR. GUASTELLA: Yes.

MR. WALKER: What is the purpose of those exhibits?

MR. GUASTELLA: In addition to complying with the PSC's filing requirements as to rate increases, the exhibits provide schedules that summarize our analyses of the Company's operations in order to establish its revenue requirement, as well as the rates necessary to produce the revenue requirement.

MR. WALKER: How do you define revenue requirement?

MR. GUASTELLA: The revenue requirement represents the level of revenues that is necessary to cover the Company's operating expenses and capital costs. The capital cost component is the return on investment that would enable the Company to maintain financial viability and attract capital.

MR. WALKER: Is that definition consistent with accepted rate setting principles?

MR. GUASTELLA: Yes. One of the guide posts with respect to rate setting is a Supreme Court decision Federal Power Commission v. Hope Natural Gas Co. 320 U.S. 591 (1944) in which revenue requirement is similarly defined, "... it is important that there be enough revenue not only for operating expenses but also for the capital costs of the business..."

MR. WALKER: Is that standard equally applicable to utilities whose stockholders are real estate developers?

MR. GUASTELLA: Yes. The basic methodology with which to establish a utility's revenue requirement does not change because of who holds the utility's stock. Revenues should cover all reasonable operating expense regardless of the identity of the stockholder. The utility should also be given a reasonable opportunity to earn a return on investment (or profit margin) that enables it to maintain financial viability and

attract capital on the strength of its own financial condition, whether or not the stockholder is a real estate developer.

MR. WALKER: Should the establishment of proper utility rates be affected by the fact that in general real estate property served by central water and sewer systems has a higher market value?

MR. GUASTELLA: Not at all. Unlike the investor-owned water and sewer utility business for which there is a need for a substitute for competition (utility regulating agencies) in order to set the price of providing service, the real estate business is high risk and highly competitive for which real estate prices reflect market values. Thus, utility regulatory agencies have no authority to set the price of real estate or the profit levels of real estate developers. Moreover, it would not be appropriate for a real estate developer's profits that were properly achieved in a competitive market, to be adversely affected through the regulation of its affiliated utility's rates.

MR. WALKER: How would an affiliated (stockholder) real estate developer's profit be affected by utility rate setting?

MR. GUASTELLA: If the developer-owned utility's revenue requirement is established below a level that would otherwise have been allowed for a utility that is unaffiliated with a developer, the developer-owner would automatically absorb the shortfall in earnings.

MR. WALKER: In the context of developer-related utilities, what are the significant characteristics that should be considered?

MR. GUASTELLA: Developer-related utilities are typically water and sewer utilities that were created because there were no other such utility services available to serve the area of the real estate project. As newly formed utilities, they did not have funding

capabilities for either the construction of the utility systems or the operating expenditures during the growth years. Over time, as customers are connected to the utility system and revenues increase, the utility operations become self-sufficient. In the meantime, the affiliated developer must provide the capital investment with which to finance the utility assets, usually booked in an intercompany account, and also subsidize the operation during the growth years, either by direct payments of utility obligations or advances to the utility through an intercompany account. Even though the utility charges compensatory rates approved by the regulatory agency, it is typical that during the growth years there is not enough revenue to cover all operating expenses and provide the developer/stockholder with a full return on its investment in the utility. Thus, the developer bears the "carrying cost" of the utility operation.

MR. WALKER: In your opinion is it proper for the developer/stockholders to absorb these carrying costs?

MR. GUASTELLA: Yes. The developers, not utility ratepayers, should absorb carrying costs because they should bear the risk of the success or failure of their real estate projects. I would note that such carrying costs are automatically borne by the affiliated developers because regulatory agencies only allow rates that cover the costs associated with the provision of utility service, and they guard against situations in which substantially less than a full compliment of customers would pay the cost of operating a completed utility system. It is also well recognized that past operating deficits are not allowed in setting prospective rates -- retroactive rate setting is not permitted. Thus, the carrying costs absorbed by the developer are never passed on to utility customers through rates for utility service.

MR. WALKER: Are there any indications that the developer/stockholder of KIU absorbed the costs associated with the creation of the utility and bore the risk of the real estate project?

MR. GUASTELLA: Yes. First, my review of the rate decisions by the South Carolina Public Service Commission regarding KIU indicates that the only costs reflected in the utility rates are those necessary to provide utility service. I also found that KIU carries significant negative retained earnings on its balance sheet, a reflection of accumulated operating deficits. Clearly, the developer not only absorbed part of the cost of operating the utility over the years, it did not earn a full return on its investment in KIU. It is, therefore, readily apparent that the developer bore, as part of its real estate project, the cost and financial risk related to the creation of KIU.

MR. WALKER: Are you satisfied that the revenue requirement you propose for KIU includes only the costs associated with the provision of water and sewer service?

MR. GUASTELLA: Yes. There are no components of cost included in the revenue requirement that are attributed to or assignable to the real estate operation.

MR. WALKER: Mr. Guastella, were the schedules prepared by you or under your supervision submitted to the South Carolina Public Service Commission as part of KIU's application for a rate increase?

MR. GUASTELLA: Yes.

MR. WALKER: What test year did you use to establish the Company's revenue requirement?

MR. GUASTELLA: The test year is calendar year 2000 with adjustments for known and measurable changes.

MR. WALKER: Now I am going to go through the various schedules you prepared that are part of KIU's application for an adjustment in rates and charges. Would you please describe Schedules A.1 and A.2?

MR. GUASTELLA: Schedule A.1 contains the Company's comparative balance sheets as of December 31, 1999 and 2000. Schedule A.2 contains the Company's income statements for the years 1999 and 2000.

MR. WALKER: Were the figures in these schedules taken from the actual financial statements provided by the Company?

MR. GUASTELLA: Yes.

MR. WALKER: Would you please describe Schedule A.2?

MR. GUASTELLA: Schedule A.2 reflects the Company's combined (water and sewer) capital structure as of December 31, 2000. It shows the calculation of a weighted cost of capital using the embedded cost of debt of 8.1375% and an 11.5% rate of return on equity. The capital structure was synchronized to the Company's combined rate base. The equity return of $540,254 produced by the traditional weighted cost of capital calculation and the use of an 11.5% equity rate yields an operating margin of 10.75% under the PSC's method of calculating operating margins, which is also shown on this schedule.

MR. WALKER: Would you explain why you believe a 10.75% operating margin is reasonable for KIU's water and sewer operations on a combined basis?

MR. GUASTELLA: The operating margin must generate enough income to provide equity investors with a reasonable return on existing investment and to enable the utility to attract capital. One analysis that can be used to judge the reasonableness of the

operating margin is to compare the result with the level of return on equity that it generates. I have made that comparison as shown on Schedule A.3

Another analysis is to compare the operating margin with those of other utilities of similar size. I have prepared Schedule A.4 for that purpose.

MR. WALKER: Would you please describe this Schedule A.4?

MR. GUASTELLA: Schedule A.4 sets forth certain operating data for investor-owned water utilities, taken from statistics compiled by the National Association of Water Companies for 1999. We have segregated that data into four groups. The data in the first column are for all reporting companies. The next two columns reflect data for utilities with revenues ranging from $5-10 million and $1-5 million, respectively. The last column reflects data for utilities in the "South Region" which includes South Carolina.

The operating margin of 10.75% that would be produced by the proposed revenue requirement for KIU compares quite favorably with the companies shown on Schedule A-4. For the group with revenues in the range of $1-5 million, where KIU falls, the average operating margin is 14.45%. The operating margin is 12.48% for the South Region and 14.0% for all companies. The only average operating margin that is less than 10.75% is for the group for which the revenues are considerably higher ($5-10 million). This group has the fewest number of companies (8), and it is expected that such larger utilities would have less risk and a lower operating margin.

MR. WALKER: In developing the separate revenue requirements for KIU's water and sewer operations, do you use the same operating margin?

MR. GUASTELLA: No. While KIU's financial integrity and its ability to attract capital are properly measured on a company-wide basis, the combined return requirement should be allocated to the water and sewer operations. This allocation is appropriate in order to establish water and sewer rates that reflect the return requirement in relation to the net investment in the utility plant and facilities used to provide the different type of utility service.

MR. WALKER: How is this allocation of return requirement derived?

MR. GUASTELLA: We derived the return requirement for water and sewer operations on Schedules W-D and S-D, respectively. These schedules are both similar to Schedule A.3, showing the capital structure synchronized to the water and sewer rate bases, respectively, using the same debt and equity rates. These schedules also show the resultant operating margins, which are 9.41% for water (Schedule W-D) and 13.88% for sewer (Schedule S-D).

MR. WALKER: Why are the operating margins different for water and sewer operations?

MR. GUASTELLA: The reason for the difference is that the equity return is a function of rate base. The water rate base is about 2 times water revenue, while the sewer rate base is about 3 times sewer revenue. Because the ratio of investment to revenue is greater for the sewer utility, it is reasonable to expect that the ratio of equity return to revenue (operating margin) would be higher for the sewer operation. As I previously stated, this is an appropriate method of allocating the overall, company-wide return requirement. I would note that even if the water and sewer operations were under

separate corporations that financed independently, their respective operating margins would also compare favorably to those of the other utilities shown on Schedule A.4.

MR. WALKER: Am I correct that the remaining schedules contain the revenue requirement components for the water operations, with the first letter designation "W", and the next set of schedules is for the sewer operations with the first letter designation "S"?

MR. GUASTELLA: Yes.

MR. WALKER: Would you please describe Schedule W-B?

MR. GUASTELLA: Schedule W-B shows the calculation of the rate base for the water operations. The first column shows the test year (2000) amounts. The next column contains adjustments for known and measurable changes, with the last column showing the "As Adjusted" figures.

MR. WALKER: Where do you identify the basis for the adjustments?

MR. GUASTELLA: The rate base adjustments are explained on Schedule W-B.1.

MR. WALKER: Where do you show the detail figures for utility plant in service and accumulated depreciation?

MR. GUASTELLA: Those figures, by primary plant account, are contained on Schedules W-B.2 and W-B.3, respectively.

MR. WALKER: In your opinion, is the utility plant in service used and useful?

MR. GUASTELLA: Yes. I found the utility plant in service to be entirely used and useful in providing service. "Used and useful" is a regulatory rate setting term related to the inclusion of utility plant in rate base. Because KIU must have sufficient facilities available to provide service to new customers, there must be adequate capacity in each

component of the utility systems in order to do so. Utility systems should also be designed in recognition of economies of scale so that the ultimate cost of providing service will not be more than necessary. In general, KIU's systems do not have "excess" capacity in terms of used and useful considerations.

MR. WALKER: Did you review the used and useful consideration with respect to the Ocean Course Drive extension?

MR. GUASTELLA: Yes. First, I would not have singled-out that extension in light of the relatively small phases that KIU's growth is requiring. Because this was an issue in the 1992, 1996, and 1998 rate proceedings, however, I did make a separate analysis of this extension. I found that the existing extension could accommodate some 203 lots, or 285 equivalent residential connections (ERCs). Of the total potential ERCs, there are 186 ERCs connected to the main. Adjusting the connected ERCs by the 75% factor used by the PSC Staff in the last case, and allowing for 2 years of growth, the calculation supports the conclusion that even this particular extension should be considered entirely used and useful.

MR. WALKER: Would you briefly explain the calculation of the working capital allowance?

MR. GUASTELLA: The working capital allowance is based on the formula for monthly billing, which recognizes 45 days from the mid-point of the billing period to the collection of revenues, divided by 360, or one-eight. The working capital allowance takes one-eight of the operation and maintenance expenses, less the amounts of the amortizations for which average unamortized balances are included directly in rate base.

MR. WALKER: Why are unamortized balances included in rate base?

MR. GUASTELLA: The expenses include the amortization of such costs as rate case expenses, tank painting and other expenses, the recovery of which is spread over time in order to reflect a normalized level for the test year. Because the expenditures were made but will not be recouped on a current basis, there is a time value that must be recognized if the Company is to be made whole for the cost of serving the customers. The inclusion of the average unamortized balances in rate base allows for that cost recovery.

MR. WALKER: Would you please describe Schedule W-C?

MR. GUASTELLA: Yes. Schedule W-C is a statement of operations, showing the test year, adjustments for known changes and as adjusted under present rates. It also shows the proposed revenue increase and the adjustments necessary to achieve the 9.41% operating margin for the water operations. You will recall that the 9.41% operating margin was developed on Schedule W-D as discussed earlier.

MR. WALKER: Would you describe Schedule W-C.1?

MR. GUASTELLA: Schedule W-C.1 contains an explanation of the adjustments to revenues and expenses.

MR. WALKER: Would you describe Schedule W-C.2?

MR. GUASTELLA: Schedule W-C.2 is a summary of the unadjusted test year operating expenses, a filing requirement.

MR. WALKER: Would you describe Schedule W-C.3?

MR. GUASTELLA: Schedule W-C.3 lists the line item operation and maintenance expenses for the test year, a filing requirement.

MR. WALKER: Am I correct that you have made no adjustment to the management fees charged by Kiawah Resort Associates, L.P. ("KRA")?

MR. GUASTELLA: Yes, I found the management fees charged by KRA to be reasonable.

MR. WALKER: How did you reach that conclusion?

MR. GUASTELLA: On the basis of information provided by the Company, I found that the management fees cover the typical administrative and general services necessary for the proper conduct of a utility business. The personnel involved include officers responsible for the overall policy and the day-to-day oversight of the business. This level of management reviews and approves budgets and financial statements, monthly and annually. It has responsibility for review, approval and disbursement of purchases and payments; review, approval and participation in connection with work by outside contractors, consultants and attorneys; insurance and tax matters; personnel and payroll; environmental and economic regulatory compliance; public relations; and capital projects. The management fee also includes the routine secretarial, mailroom and general office services. In addition, the management fee covers the office structures, office equipment and related costs. There are some seven people involved in this management level of service, which are not direct KIU's employees.

The amount of the management fee for the combined water and sewer operation is $100,000. In my opinion this fee is modest and is only achievable because of KIU's relationship with a parent corporation that is able to share personnel and offices.

We also made a comparison of KIU's total payroll and management fees with other water utilities. Referring to Schedule A.4, the data for the companies shown

indicate that total payroll expenses represent about 23% of total operation and maintenance expenses—the ratio is about 29% for the South Region. KIU's total payroll and management fees are only 19% of its total operation and maintenance expenses. While rates for one utility are not a basis on which to establish rates of another utility, clearly KIU compares favorably in terms of payroll and management fees. Certainly, we find no basis on which to suggest a downward adjustment to the management fee.

MR. WALKER: Would you please describe Schedule W-C.4?

MR. GUASTELLA: Schedule W-C.4 shows the calculation of depreciation expense for the test year, which is based on the application of the Company's depreciation rates to the balances in the primary plant accounts.

MR. WALKER: Would you please explain Schedules W-E, W-E.1, and W-E.2?

MR. GUASTELLA: These schedules contain billing analysis data. Turning first to Schedule W-E.2, the billing analysis is shown for the test year 2000, and reconciles to within 1.0% of booked revenues. It shows all the bills rendered by meter size and customer class, the consumption by rate block, and the revenues produced by multiplying the billing units by the existing rates.

Schedule W-E.1 is a similar billing analysis under present rates, but the billing units and revenue are higher because we annualize customer growth.

Schedule W-E is a billing analysis under the proposed rates necessary to achieve the proposed revenue requirement. The billing units include annualized bills as shown on Schedule W-E.1, and also accounts for customer growth as a known and measurable change For the most part, we maintained the existing rate structure,

including the step up rate blocks. We did, however, eliminate the minimum water allowance of 2,000 gallons per month in order to establish a service charge and usage rate that is more typical of industry practice.

MR. WALKER: Am I correct that both the current and proposed schedules of rates and charges have been filed with the PSC as part of the Company's application?

MR. GUASTELLA: Yes, these are filed as Appendices C and D.

MR. WALKER: Is the Company proposing any new tariff provisions?

MR. GUASTELLA: Yes. In addition to the conversion from a minimum charge with a water allowance to a service charge with no water allowance, the Company is proposing a new rate Schedule No. 8 – Standby Service - Golf Courses and a Purchased Water Adjustment Clause.

MR. WALKER: Would you please explain the reason for the proposed Standby Service rates?

MR. GUASTELLA: The reason for the Standby Service rates is to provide for the recovery of the cost of having facilities available to meet potentially large water demands of a customer, in this case a golf course that has its own alternative source of supply and does not take water from the Company on a continuous basis. When regular customers, including large use customers, take water on a continuous basis, the cost of meeting their demands, average and maximum, are recovered over the course of billing for a year under the tariff schedule (which is designed for such circumstances). If, however, a potential large user of water, such as a golf course, is not taking water service from the Company on a continuous basis, but would only occasionally impose a large demand for water on the Company's system, the cost of having facilities available

MR. GUASTELLA: The second component is a usage charge for the actual water used by a Standby customer. It reflects the same usage rates as proposed for the golf courses that are continuous customers.

MR. WALKER: How would the Standby Rates be implemented?

MR. GUASTELLA: Any golf course with its own alternate source of supply that would rely on the Company to meet its water demands in the event its own alternate source became unavailable, would be required to enter into an agreement with the Company for Standby Service (a copy of the proposed agreement has been included in the Company's application at page 8 of Appendix C). The level of the CMDSD would be established in that agreement.

MR. WALKER: Would the Company and its customers be protected in the event a Standby Service customer exceeds its CMDSD or fails to enter into a Standby Service Agreement?

MR. GUASTELLA: Yes. There are provisions in the Standby Service Rate Schedule No. 8 that correct for those circumstances. Briefly, if the Standby customer's actual demand is higher than the CMDSD, the higher demand would become the new CMDSD. For failure to enter into an agreement, the Standby Rate would be applied as if an agreement had been entered into. In each instance, the revised charge or new charge would be applied since the time the contract was or should have been entered into, or for 24 months, whichever is less.

MR. WALKER: Does the Company now have a Standby Rate customer?

MR. GUASTELLA: No. It is my understanding, however, that the potential for such a customer exists. It is, therefore, prudent to establish the Standby rate now so that the

Company and its customers will be protected in the event such a service become necessary in the future.

MR. WALKER: Am I correct that the other new tariff item is a Purchased Water Adjustment provision?

MR. GUASTELLA: Yes.

MR. WALKER: Would you please explain this provision?

MR. GUASTELLA: The Purchased Water Adjustment provision is a mechanism under which the Company would be able to recoup any actual increase in its purchased water costs. The calculation of the rate change that would be implemented, after notice and review, to recoup the purchased water increase is straight-forward and explained in the Purchase Water Adjustment provision set forth on page 9 of Appendix C to the rate application. Essentially, the rate would be increased (or decreased), after PSC approval, to precisely account for any change in either the unit price component or operation and maintenance component of the charges by St. John's Water Company.

MR. WALKER: Why is it important to establish this Purchased Water Adjustment?

MR. GUASTELLA: Purchased water costs represent about 73% of the total water operations and maintenance expenses, and accounts for the expenditure of about 46% of total revenues. On the other hand, the proposed net income or operating margin for the water operation represents only 9.4% of revenues. Thus, even a relative small increase in purchase water costs would significantly impact the allowed return on equity; a 10% purchase water increase would cut the equity return in half.

The purchase water adjustment would provide the Company with a reasonable opportunity to achieve its allowed return on equity. It would also preclude the necessity

MR. WALKER: In your opinion, are the proposed rate increases for KIU's water and sewer operation reasonable?

MR. GUASTELLA: Yes. The proposed rate increases are designed to cover the KIU's cost of providing water and sewer service, and if approved would give KIU an opportunity to earn a reasonable operating margin.

THIS ENDS MY DIRECT TESTIMONY